Major Provisions of Finance Committee's Tax Bill

The sweeping tax overhaul bill approved by the Senate Finance Committee early in the morning of May 7 would increase the tax burden on corporations by $105 billion to $110 billion over five years, while reducing the burden on individuals and cutting some miscellaneous taxes by about the same amount. Most individual taxpayers would receive a tax cut. *(Tax liability by income class, table, p. 1013)*

The shift would be accomplished by reducing the top tax rate for individuals by nearly half and that for corporations by more than one-fourth, and by eliminating or significantly curtailing exemptions, deductions and credits used by taxpayers to reduce their payments.

Although the panel voted 20-0 to order the bill reported, staff director Bill Diefenderfer said senators had agreed to "concepts" only, and that it would be up to the committee staff, in consultation with individual senators, to draft the precise legislative language that would go to the Senate floor. As a result, the details of some provisions might not be clear for several weeks, and could differ from what is presented below.

Estimates of the revenue effect of many provisions were not available, and staffers cautioned that estimates that were available could be subject to major revision.

Most provisions would take effect Jan. 1, 1987; where known, those with other effective dates are noted.

The House-passed tax overhaul bill (HR 3838), though similar in that it also would chop rates and curtail tax breaks, differs in several key respects. It would shift about $140 billion in tax burden from individuals to corporations, but would not make so many dramatic alterations in the code as would the Finance bill. *(House committee action, 1985 Weekly Report p. 2483; committee provisions, p. 2492; floor action, p. 2705)*

Individual Tax Changes

- **Individual Rates.** Replace the existing 14 tax brackets (15 for single taxpayers) ranging from 11-50 percent with two brackets — 15 percent and 27 percent.

  For single taxpayers, the 27 percent tax bracket would apply to taxable income of $17,600 or more. The graduated income tax would be phased out for single taxpayers with incomes between $45,000 and $87,240. For those with taxable income above $87,240 the 15 percent rate would not apply, and all income would be taxed at 27 percent.

  For joint returns, the top rate would apply to taxable income of $29,300 or more, and the 15 percent bracket would be phased out for incomes of between $75,000 and $145,320.

  Single heads of households would begin to pay a 27 percent rate on taxable income of $23,500 or more and the lower bracket would be phased out between $55,000 and $111,400.

  The new rates, which would be indexed annually to reflect inflation, would go into effect July 1, 1987.

- **Standard Deduction.** Set the standard deduction allowed those who do not itemize deductions at $3,000 for individuals, $5,000 for joint returns and $4,400 for single heads of households. The existing standard deduction (the so-called zero-bracket amount) is $2,480 for individuals and single heads of households and $3,670 for joint returns.

  The new standard deduction would be indexed to rise with inflation; it is not clear when this provision would become effective. An additional $600 standard deduction would be allowed for the elderly and the blind.

- **Personal Exemption.** The existing $1,080 personal exemption for taxpayers and dependents would be raised to $1,900 in 1987 and $2,000 in 1988. The amount would be indexed for inflation in later years.

  The exemption would be phased out gradually for individuals with incomes between $87,240 and $127,240, for married couples with incomes between $145,320 and $185,320 and for single heads of households with incomes of between $111,400 and $151,400.

  Individuals who can be claimed as dependents by other taxpayers would not be allowed their own personal exemptions.

- **Earned Income Tax Credit.** Retain the current-law earned income credit for poor persons, but increase the benefit. The cost of the increased benefit is expected to be at least $700 million over five years, but Finance Committee staffers have yet to determine exactly how it should be computed. Increasing the income level at which the credit would be phased out was considered the likeliest technique for making the credit more generous.
- **Rounding.** Adjust downward to the nearest $50 the standard deduction, personal exemption and rate brackets, and possibly the earned income tax credit, when indexed for inflation in future years.
- **Two-Earner Deduction.** Repeal the deduction now allowed married couples filing joint returns. The deduction was designed to eliminate the so-called "marriage penalty," which caused working couples filing jointly to pay higher taxes than if they had been able to file separately as single taxpayers.
- **Income Averaging.** Repeal the ability that taxpayers with fluctuating incomes now have to average their incomes over a period of years to reduce their tax liability when they have a large increase in income.
- **Elderly and Disabled.** Retain current law allowing a 15 percent tax credit for individuals aged 65 and over, or those who have retired on permanent and total disability.
- **Unemployment Compensation.** Tax all unemployment benefits as income. Currently, such benefits are taxed only if the benefits, in combination with a taxpayer's adjusted gross income, exceed $12,000 for individuals and $18,000 for joint returns. Workers' compensation and black lung disability payments would not be subject to tax, as under current law.
- **Scholarships and Fellowships.** Retain current law governing the taxation of scholarships and fellowships. Generally, such amounts are not taxed for degree candidates.
- **State and Local Taxes.** Retain full deductions for state and local income, personal property and real estate taxes. Deductions for state and local sales taxes would be eliminated.
- **Charitable Contributions.** Allow the deduction now allowed those who do not itemize deductions to expire at the end of 1986. Itemizers would continue to be allowed to deduct charitable contributions.
- **Adoption Expenses.** Retain the existing deduction for up to $1,500 of adoption expenses for handicapped or other hard-to-place children.
- **Ministers and Military Personnel.** Allow ministers and military personnel receiving tax-free housing allowances to deduct mortgage interest or real property tax payments.
- **Medical Deductions.** Increase from 5 percent to 10 percent the amount of adjusted gross income that a taxpayer's medical expenses must exceed before such expenses may be deducted.
- **Travel and Entertainment.** Allow only 80 percent of business meal and entertainment expenses to be deductible, except that expenses for banquets would be fully deductible. Deductions for travel made solely for educational purposes would not be allowed; deductions for luxury water transportation would be limited. No deductions would be allowed for attending investment seminars or conventions.

- **Child Care.** Retain the current child and dependent care tax credit of up to $720 a year for one dependent and up to $1,440 for two dependents.
- **Miscellaneous Deductions.** Deductions for miscellaneous job expenses, such as union dues, would not be allowed. Certain other unreimbursed employee business expenses, however, such as transportation costs, would be deductible only for itemizers and only to the extent they exceed 1 percent of adjusted gross income.
- **Home Offices.** Limit deductions for home offices to a taxpayer's net income from the business. Currently the deduction cannot exceed gross income. The limits would also apply to cases where a taxpayer leases a home office to his employer.
- **Hobbies.** Expand the definition of "hobbies" for which expense deductions are more limited than for regular businesses. An activity would be a hobby if it is not profitable in at least three out of five consecutive years, instead of two out of five years as under current law. Horse breeding and racing would be exempt from the tightened restrictions.
- **Political Contribution Credit.** Repeal the existing $50 credit ($100 for joint returns) for contributions to political campaigns and certain political campaign organizations.
- **Presidential Campaign Checkoff.** Continue to allow taxpayers to check off a box on their tax returns to allocate $1 ($2 for joint returns) of their tax liability to the Presidential Election Campaign Fund.

Depreciation

- **Accelerated Depreciation.** Generally retain the Accelerated Cost Recovery System of depreciation and permit faster write-offs through use of a 200 percent declining balance method in place of the current 150 percent. However, the depreciation would be applied over a longer period of time for some property.

  Among the changes from current law: Some long-lived manufacturing property would be taken out of the five-year class and would have to be depreciated over 10 years, as would oil refinery equipment; research and experimentation property would be moved from the three-year class to the five-year class until Dec. 31, 1989, when it would revert to the three-year class; property in the three-year class would be depreciated either straight-line (as for autos) or at the 150 percent rate.

  Real estate would be hit hardest by the changes with the depreciable life of such assets expanded from the current 19 years (15 years for low-income housing) to 27½ years for residential property and 31½ years for commercial. In addition, such investments would have to be written off over the straight-line method, meaning that larger write-offs would not be allowed in the early years of the investment as under current law.

  President Reagan wanted the value of depreciation deductions to be indexed to reflect increases in inflation, but the committee did not go along.
- **Investment Tax Credit.** Repeal the 10 percent (6 percent for certain short-lived investments) tax credit now allowed for a taxpayer's investment in certain property. The change would be effective retroactively to Jan. 1, 1986.

  Only 70 percent of the value of unused investment tax credits could be used to offset past or future tax liability. Currently, firms can carry the full amount of unused credits forward 15 years or back three. The committee dropped a controversial proposal by Chairman Bob Packwood, R-Ore., for the government to buy 70 percent of the value of a firm's unused credits.
- **Small Business.** Allow small firms to write off in one year, or "expense," up to $10,000 in personal property investments. The current ceiling is $5,000; Packwood initially had proposed a $50,000 cap that won accolades for the bill from the small business community.

Accounting

- **Installment Sales.** Eliminate the tax benefits home builders, retailers and others can realize by borrowing against the future repayments of home mortgages and installment sale contracts.

  The change would eliminate the use of "builder bonds," which allow home builders to receive cash for new developments by borrowing against mortgages they have provided home buyers. Packwood's original insistence on exempting builder bonds from the installment sales restrictions to help the housing industry, and thus the Oregon timber industry, caused many members of the Finance Committee to demand similar tax breaks for home-state economic interests. Builders can, in effect, defer paying taxes on the gain from such sales, while currently enjoying the benefit of the loans.
- **Long-Term Contracts.** Restrict the use of a method of accounting that allows defense and other contractors to delay tax payments until work on a project has been completed, and often to reduce dramatically or eliminate their tax liability.

  Current law would be retained for real property construction contracts requiring less than two years to complete for firms with average annual gross receipts of $10 million or less.
- **Bad-Debt Reserves.** Prevent businesses from taking deductions for reserves held to cover bad debts. Instead, deductions would be allowed when specific loans become partially or wholly worthless.

  An exception would be provided for financial institutions, which could continue to benefit from the bad-debt reserve deduction, although it would be limited for thrifts.
- **Savings and Loan Associations.** Allow thrift institutions to carry losses forward eight years as deductions against income, rather than five years as under current law, in recognition of severe losses incurred by the industry since 1982.

  To pay for this change, the committee agreed to limit bad-debt reserves deductions by savings and loans.
- **Inventories.** Require wholesalers and retailers with sales of $5 million or more a year to capitalize over a period of time certain inventory costs rather than to deduct the costs in one year.

Capital Gains

- **Individuals.** Repeal the 60 percent capital gains exclusion for individuals. The impact would be to subject income from capital gains to the same tax rate as ordinary income (i.e., 15 percent or 27 percent). Currently, the top effective tax rate for long-term capital gains is 20 percent (resulting from a 50 percent rate imposed on 40 percent of an individual's capital gains income).
- **Corporations.** Retain the current-law corporate capital gains rate of 28 percent.

Compliance

- **Internal Revenue Service.** Provide increased funding for agents, audits and modernization, to be paid for by the interest and penalty receipts the enhanced enforcement is expected to bring in. Total collections over five years are projected to reach $31 billion.
- **Penalties.** Increase assorted penalties for failure to pay taxes or to file required information with the IRS. Penalties for tax underpayments would be increased from 10 percent to 20 percent of the underpayment.

Information reporting requirements to the IRS would also be expanded. For example, oil and gas royalties in excess of $100 would have to be reported to the IRS; current law requires reporting of royalties in excess of $600.

- **Estimated Tax Payments.** Increase estimated tax payments for individuals who do not have enough taxes withheld to the lesser of 100 percent of the previous year's tax liability or 90 percent of the current year's liability.
- **Voluntary Disclosure.** Direct the Treasury secretary to implement and publicize a longtime IRS policy that individuals who voluntarily disclose past failure to pay taxes be given special consideration in any decision to prosecute. The provision, proposed by Max Baucus, D-Mont., was adopted in place of a more far-reaching federal tax-amnesty proposal, which was roundly criticized by tax administrators. *(Weekly Report p. 542)*

Corporate Taxes

- **Corporate Tax Rate.** Reduce from 46 percent to 33 percent the top corporate income tax rate. Taxable income of $50,000 or less would be taxed at a rate of 15 percent; income of $50,000 to $75,000 would be taxed at 25 percent and income above $75,000 would be taxed at the 33 percent rate.

  The graduated tax would be phased out so that the two lower rates would not apply, and corporations with taxable incomes of about $350,000 or more would pay a flat 33 percent.
- **Dividends.** Repeal the $100 exclusion now allowed for dividends received by an individual ($200 for joint returns). The committee rejected a Reagan proposal to allow corporations to deduct 10 percent of the dividends they pay to stockholders.

  The bill also would reduce from 85 percent to 80 percent the percentage of dividends received that could be deducted by a corporation.
- **Business Tax Credits.** Reduce from 85 percent to 75 percent the percentage of tax liability in excess of $25,000 that can be reduced by business tax credits.

Oil and Gas, Timber, Natural Resources

- **Agriculture.** Allow farmers to continue writing off in one year the cost of soil and water conservation measures, instead of depreciating the costs over several years, provided the improvements were consistent with Agriculture Department approved plans. The deduction would be limited to 25 percent of farm income.
- Retain one-year write-offs for certain fertilizer and soil conditioning costs, but repeal the write-off for land-clearing expenses.
- Exempt certain farmers from accounting rules to which they would otherwise be subject, as under current law. Farmers using the cash method of accounting could not deduct the prepaid costs of seed fertilizer or other expenses, if they were used in the year following prepayment, and if more than 50 percent of the farmer's costs are prepaid.
- **Timber.** Retain special capital gains treatment for corporations on the proceeds from timber sales (as noted above, capital gains for individuals would be treated as regular income).
- Allow taxpayers a 10 percent tax credit for reforestation costs, and allow up to $10,000 annually of such costs to be written off over seven years, as under current law.
- Allow most costs for timber production to be written off in the year paid or incurred, as under current law.
- **Oil and Gas.** Retain the current-law percentage depletion allowance for independent oil and gas producers and royalty owners, for up to 1,000 barrels of daily production.

  Percentage depletion, one of the key tax breaks for independent producers, allows taxpayers to deduct up to 15 percent of their gross income each year to cover the cost of depletion of their wells. Taxpayers can continue to claim the deduction, even after they have recovered all expenses related to acquiring and developing the property.

Oil refiners would lose the ability to write off depreciation over five years, but the industry's tax breaks largely would be protected by the Finance Committee bill.

- Allow oil, gas and geothermal property owners to write off in one year so-called "intangible drilling costs," such as labor and fuel, as under current law.
- **Coal, Iron and Hard Minerals.** Retain special capital gains treatment for corporations for royalties from coal and iron ore held for six months before mining, as under current law (as noted above, capital gains for individuals would be treated as regular income). The special percentage depletion allowance would not apply to the same coal or iron ore, as under current law.
- Allow taxpayers to write off exploration and development costs for mines and other hard mineral deposits in one year, except that exploration costs must be recovered against depletion deductions, as under current law. Corporations would be allowed to write off in one year 80 percent of such costs, and write off the remainder over five years.
- Retain current law allowing a depletion deduction based on a percentage set in law that ranges up to 22 percent.
- **Energy Tax Credits.** Reinstate business energy tax credits. Residential credits would be allowed to expire as under current law.
- **Alcohol Fuels.** Retain the 6-cents-per-gallon exemption from federal fuel excise taxes for fuels containing 10 percent alcohol. The current 9-cents-per-gallon excise tax exemption for fuels that are at least 85 percent alcohol would be reduced to 6 cents.

  The existing 60-cents-per-gallon tax deduction for alcohol purchased to be mixed with gasoline or diesel fuel would be repealed.

Foreign

- **Foreign Tax Credits.** Make a number of changes limiting the ability of firms to use foreign tax credits to reduce their U.S. income tax liability and raising taxes on foreign firms doing business in the United States. However, it would repeal the Foreign Investment in Real Property Tax Act, which requires withholding by a responsible party, generally a broker, of taxes on gains by foreigners from sales of real estate holdings in the United States.

  The committee rejected a Packwood proposal to impose a 5 percent withholding tax on interest payments made to foreigners.
- **Income Exclusion.** Reduce the current $80,000 exclusion of income earned by Americans working abroad to $70,000. The bill also would add Libya to the list of countries to which the exclusion does not apply.

Interest

- **Home Mortgages.** Continue full deductions of interest payments on mortgages for first and second homes.
- **Consumer Interest.** Phase out over three years all deductions for consumer interest payments.

  Taxpayers with investment income would be allowed to deduct interest paid on borrowings used to make the investments, but such deductions would be limited to the amount of investment income.

Minimum Tax

- Impose a 20 percent minimum tax on corporations and individuals who otherwise would be able to reduce their tax liabilities dramatically through the use of tax breaks retained in the law.

  Minimum taxes are imposed under current law on both individuals (20 percent) and corporations (15 percent), but there are so many loopholes that many individuals and corporations still escape paying tax.
- **Individuals.** Retain the basic structure of the tax, but add some new preferences and subtract others from the list that goes into the calculation of the tax. The $70,000 in tax-exempt income that may be earned by Americans who work abroad would be eliminated from the list of taxable preferences. The benefits of investing in most tax shelters, which would be eliminated entirely over five years by other sections of the bill, would become subject to the minimum tax in 1987, without any phase-in. The interest on tax-exempt bonds would remain uncovered by the minimum tax, despite considerable talk earlier about including it.
- **Corporations.** Redesign the corporate minimum tax with the objective of making it close to airtight. A two-level method of figuring the tax would be used.

  A company would, first, calculate its taxable income under existing law, including all the various deductions, exemptions and exclusions. Then, starting with taxable income, it would add these preferences back and make other adjustments, and from this calculate minimum taxable income. Next it would compare this minimum taxable income total with "book income," as reported to shareholders or a regulatory agency or a bank for purposes of obtaining a loan. If the book income is more than the minimum taxable income, it would add one-half of the difference to the minimum taxable income and calculate the tax on this total amount at a 20 percent rate. A few current preferences would remain uncaught, even with the use of the book-income concept. One of the largest is the expensing of research and development costs.

Pensions

- **Individual Retirement Accounts (IRAs).** Restrict the current deduction for IRA contributions to those taxpayers who are not covered by employer-provided pension plans, including so-called "401(k)" tax-deferred savings plans.

  Taxpayers ineligible to make tax-deductible contributions could continue to add to IRAs, although the contributions would be taxable. The interest earned by IRAs held by taxpayers ineligible for tax deductible contributions would continue to be tax-deferred, however.
- **401(k) Plans.** Reduce the maximum elective employee contribution to a tax-deferred savings plan from $30,000 a year to $7,000. The bill would clarify that non-profit organizations are allowed to offer 401(k) plans.
- **Federal Retirees.** Eliminate a provision in current law allowing public employees to receive tax-free pension benefits until the benefit payments exceed the total contributions made by the individual to his pension plan. Instead, the tax-free portion of the benefits would be spread out over the retiree's life expectancy.

  The change would be phased in, so that individuals retiring next year would not be affected. Those retiring in 1988 would have half of their contributions covered by the new rule and half covered under current law. Those retiring in 1989 or after would come under the new provision.
- **Other Pension Changes.** Make sweeping changes in tax laws governing private pension plans in an attempt to encourage firms to provide greater coverage for their lower- and middle-income employees. Generally the changes would be effective for pension plan years beginning after Dec. 31, 1988.
- Require firms to cover 80 percent of their employees with a pension plan for that plan to qualify for special tax treatment.

  Currently, employers are required to cover only 56 percent or "a fair cross-section" of workers, a loose test of whether a pension plan treats employees fairly. Employers could still use the "fair cross-section" standard, but would then be required to provide all employees with at least 60 percent of the benefits received by those fully covered by the pension plan.
- Provide full vesting of employees in pension plans after five years on the job, instead of the current 10 years.
- Prohibit an employer from limiting an employee's retirement benefits by more than 50 percent, if the employer takes Social Security benefits into account when calculating the employee's benefits. Currently, some workers can have their pension benefits entirely eliminated because anticipated Social Security benefits exceed the anticipated pension amount.

Fringe Benefits

- **Overall.** Retain generally current law allowing tax-free employer-provided fringe benefits.
- **Prepaid Legal Services.** Make permanent an exclusion from taxable income of employer-provided prepaid legal services, which expired at the end of last year.
- **Education Assistance.** Make permanent the exclusion from taxable income of employee education assistance and adjust the current $5,000 cap to rise with the Social Security wage base.
- **Health Insurance.** Allow self-employed individuals to deduct half of their health insurance premiums when calculating their income tax liability. However, the costs would not be deductible when figuring self-employed Social Security payments. Currently, such costs are not deductible at all for self-employed individuals.

Research and Development

- **Tax Credit.** Extend for four years, until Dec. 31, 1989, a 25 percent tax credit for new research and development expenditures. High-tech industries lobbied strongly for the credit extension.

Tax Shelters

- **Real Estate.** Eliminate provisions allowing so-called passive losses generated by investments in limited partnerships in real estate and most other types of tax shelters. Such losses currently may be used to reduce wage or other income for tax purposes.

  Passive losses arise principally from depreciation deductions, and investment tax and other credits which are large in the early years of investments. A typical shelter investor sells out of the partnership when income from the real estate starts to exceed the deductions. Depreciation deductions then start all over again for the new buyer. It is this process that the bill is designed to stop.

- **Oil Shelters.** Create a new class of passive losses in cases where an investor in an oil or gas drilling enterprise has a working interest in the partnership, defined as some liability beyond his original investment. The passive losses created by such deductions as the expensing of intangible drilling costs would still be permitted for working-interest partners.

Tax-Exempt Bonds

- **Public Use.** Continue to allow full deductibility for interest earned on bonds issued by state and local governments to fund government operations, such as the construction of schools or roads. The committee agreed to retain current law defining bonds as public-use bonds if no more than 25 percent of the proceeds are used by a private trade or business. The House proposed a more restrictive 10 percent test.

  Reagan had proposed elimination of the tax exemption for all bonds except those used solely for government purposes.

- **Industrial Development Bonds (IDBs).** Continue to allow tax exemptions for bonds issued for certain private purposes, subject to a cap on the amount of IDBs and student loan bonds that can be issued annually within the state.

  The existing cap of $150 per state resident would continue until Jan. 1, 1987, when it would drop to $100 per resident, as under current law.

  The House would impose a $175 per resident cap, but would dramatically expand the type of bonds that would be subject to the cap, thereby limiting the total amount of bonds that could be issued. Under the Finance Committee measure, bonds for multifamily rental housing and those issued by non-profit organizations would not be subject to the cap.

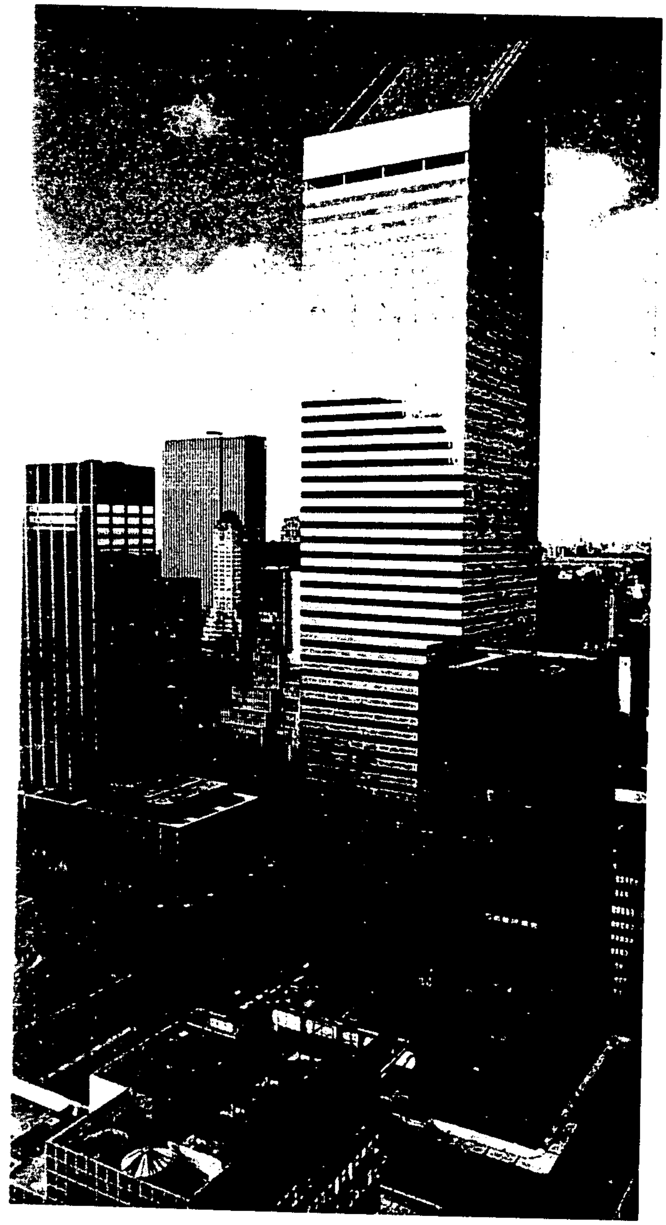
  Tax exemptions would no longer be allowed for IDBs issued to fund pollution-control equipment; sports, convention, parking and trade show facilities; industrial parks and mass transit facilities with private beneficiaries. The committee would allow a tax exemption for bonds issued to fund hazardous-waste facilities, an exemption not allowed under current law.

  The exemption for small-issue IDBs — those not exceeding $1 million — would expire at the end of this year (Dec. 31, 1988, for manufacturing facilities), as under current law.

- **Mortgage Revenue Bonds.** Retain current law "sunsetting" the tax exemption for such bonds on Dec. 31, 1987.

Miscellaneous

- **Trusts and Estates.** Tax the unearned income of a child under the age of 14 at the parent's tax rate, instead of at the child's rate, if the income is derived from assets given the child by the parent. The bill also would repeal so-called Clifford Trusts, another method used by parents to transfer income to their children to avoid taxes.



The nation's building construction boom could be curtailed by proposed limits on real estate tax breaks.

- **Targeted Jobs Tax Credit.** Extend for three years, through 1988, the credit now available for those who hire economically disadvantaged youths and other hard-to-place workers. However, the credit would be available only for wages paid in the last nine months of the first year of employment.
- **Handicapped Barriers.** Extend permanently a deduction for up to $35,000 in expenses for removing architectural and transportation barriers for the handicapped and elderly, instead of writing them off over a longer period of time. The deduction expired at the end of 1985.

—Compiled by Pamela Fessler and Eileen Shanahan